First Sentier Asian Quality Bond Fund
Monthly review and outlook

First Sentier Investors

Monthly Review and Outlook | March 2023

Market review

The Asian credit market returned +0.90% in March. Credit spreads leaked wider in Asian Investment Grade (IG) credits as the turmoil in US and Europe banking unfolded, while Asian High Yield (HY) bonds almost wiped out its year-to-date rally as Sino-Ocean's coupon deferral (SINOCE) reignited market volatility. Over the course of the month, Asian IG spreads widened 27 basis points (bps) to 195bps, and Asian HY spreads widened by 124bps to 870bps. The ensuing pessimism in economic outlook that followed the banking crisis also caused US Treasury (UST) 10-year yields to decline sharply, even amid the US Federal Reserve's (Fed) continuation to raise rates by 25bps. The steep rally in rates more than offset the widening of spreads, and that resulted in positive returns for the Asian credit market.

The Asian credit market was not spared from the global risk-off sentiments caused by the Silicon Valley Bank (SVB) fallout early in the month, as well as the write-down of Credit Suisse's Additional Tier 1 (AT1) securities. AT1 securities from Asian issuers experienced various degrees of selloff, but the spread widening seen amongst Asian credit was relatively contained compared to other markets, thanks to robust technicals and strong intrinsic credit profiles of major banks within the Asian region. While cautious of negative surprises, our findings thus far suggest that Asia would be impacted less by the collapse of three regional banks in the US and the forced sale of Credit Suisse to UBS. We expect Asian AT1s to remain more resilient than their global peers, given the higher likelihood of pre-emptive government liquidity supports for Asian banks compared with European (EU) and US banks as evidenced in previous crises. Amongst major Asian banks, negligible direct exposures to SVB and limited unrealised losses in Held-To-Maturity (HTM) investment books also bode well for weathering the market volatility that has engulfed banks in the US and Europe. In the rest of the Asian IG space, the China reopening story still remains highly supportive towards markets sentiment.

In Asian HY, China property names saw spreads widened on risk-off sentiment that followed the SVB and CS crisis. Panic selling seized the market after a benchmark name, Sino-Ocean (SINOCE), announced deferment of its coupon payment on a perpetual bond amounting to USD 20.6mil. Other privately-owned enterprises (POE) such as Country Garden saw bond prices falling 8-10 points across the curve. Citing the overwhelmingly negative market reaction, SINOCE subsequently repaid the coupon. Towards the end of the month, improved sentiments saw some price rallies amongst HY property bonds, led by Country Garden. Bond prices for SINOCE remain battered, however, as the developer received a qualified opinion from their auditor, who raised questions regarding the company's ability to continue as a going concern.

Asian sovereign bonds spreads widened following risk-off sentiments. Spreads of investment grade sovereign and quasi-sovereign bonds moved mostly in proportion to USTs, resulting in a mild effect on prices. Meanwhile, high yield sovereign bonds in markets such as Sri Lanka continued to face downward pressure, despite better clarity for bondholders in the country's debt restructuring with the IMF.

Overall issuance volume fell in March 2023. Issuance from financials experienced a pull back with the market turbulence from developed markets. Nevertheless, in the investment grade space, quality names still came to the market, such as Korea National Oil Corporation, POSCO, Export-Import Bank of Korea, and Sumitomo Corporation still garnering positive responses from investors.

- The Fund invests primarily in debt securities of governments or quasi-government organization in Asia and/or issuers organised, headquartered or having their primary business operations in Asia.
- The Fund's investments may be concentrated in a single, small number of countries or specific region which may have higher volatility or greater loss of capital than more diversified portfolios.
- The Fund invests in emerging markets which may have increased risks than developed markets including liquidity risk, currency risk/control, political and economic uncertainties, high degree of volatility, settlement risk and custody risk.
- The Fund invests in sovereign debt securities which are exposed to political, social and economic risks. The Fund may also expose to RMB currency and conversion risk.
- The Fund invests in debts or fixed income securities which may be subject to credit, interest rate, currency and credit rating reliability risks which would negatively affect its value. Investment grade securities may be subject to risk of being downgraded and the value of the Fund may be adversely affected. The Fund may invest in below investment grade, unrated debt securities which exposes to greater volatility risk, default risk and price changes due to change in the issuer's creditworthiness.
- The Fund may use FDIs for hedging and efficient portfolio management purposes, which may subject the Fund to additional liquidity, valuation, counterparty and over the counter transaction risks.
- For certain share classes, the Fund may at its discretion pay dividend out of capital or pay fees and expenses out of capital to increase distributable income and effectively a distribution out of capital. This amounts to a return or withdrawal of your original investment or from any capital gains attributable to that, and may result in an immediate decrease of NAV per share.
- It is possible that a part or entire value of your investment could be lost. You should not base your investment decision solely on this document. Please read the offering document including risk factors for details.

Fund positioning

The Fund is posturing for a volatile quarter ahead as it continues to invest cash in quality names with the ability to survive a potential downturn. Purchases were made in attractively priced Indonesian quasi-sovereigns, such as Pertamina and Indofood, as well as longer tenure Chinese technology names such as Alibaba and Tencent, as regulatory pressure eases in the Chinese technology sector.

In the primary market, the Fund participated in Sumitomo Corporation and took profit later in the month as spreads tightened.

Performance review

On a net-of-fees basis, the First Sentier Asian Quality Bond Fund returned 0.97% in March, underperforming its benchmark by -0.54%.

On a relative basis, the Fund underperformed its benchmark as overweights in Chinese property and Indonesia quasi-sovereign bonds gave up some recent gains. However, the sharp rally in US treasuries over the month offset some of the negative excess returns as the market was gripped by risk-off sentiments from the US and Europe banking crisis.

	We thought that...	Therefore, we...	And the results...
US rates	The Federal Reserve would be closer to the end of its rate hike cycle and be less aggressive in hiking rates. However, prices will remain high and the likelihood or rate cuts remains low.	Moved from a neutral to an overweight stance for US rates in the portfolio.	The Fund's overweight in US rates versus the benchmark contributed to positive returns due to the sharp rally in US rates during the month.
Asian IG	Fundamentals remain sound in Asian Investment Grade (IG) corporates but a cautious stance remains warranted following the sharp rally in the past few months.	Tactically traded high quality names in the primary and secondary markets in names that offered attractive issuance premium and still offered value.	The Fund's exposure to Chinese property names and Indonesian-quasi sovereign detracted value as spreads widened. Underweight versus the benchmark in Indonesia and Philippines sovereign partially offset the underperformance.

Q2 2023 investment outlook

Risky assets started the year in euphoria as a moderation in US inflation led the US Fed to switch to a more gradual path of rate hikes. A complete relaxation in China's zero-Covid policy further boosted market's sentiment up to a point valuations in credit markets is no longer pricing in any risk of a global recession. While uncertainty around global growth remains, the high all in yield for Asian Credit is an attractive proposition for us to stay constructive in this asset class.

US economy appears resilient of late and labor market remains tight as jobs creation surprised on the upside. Corporate earnings remain decent though outlook is looking increasingly cautious. We are of the view that the stronger than expected headline figures, especially that of the labor market is likely to have veiled the underlying weakness in the US economy. This weakness may have already started during Q4 2022, during which major US technology firms started laying off workers, a clear indication the outlook is not looking too rosy. US imports have also slowed down significantly in recent months, a trend that is highly evident as we simultaneously witnessed sharp decline in Asian exports. With interest rate now at elevated levels, we are starting to see stress in the housing market as many Americans struggle with the high mortgage rate. With consumer prices moving significantly higher, real disposable income has inevitably declined and this will significantly impact consumption going forward even if inflation is to moderate. We believe the US Fed will continue hiking policy rate at 25bps per meeting so long as unemployment rate stays low and economy continues to expand. We also believe it is inconceivable for the Fed to continue tightening without bringing about a recession. In other words, we believe a recession is imminent. The only question is when it will happen and how deep it gets.

Similar to the US, Eurozone economy held up well despite the numerous challenges it faces which include the Russian-Ukraine war. Inflation though remains a serious problem and looks to be much worse than that in the US at this juncture. This means the ECB will likely remain hawkish and play catch-up on policy tightening with the US Fed. Nevertheless, we do take some comfort that the region is now better prepared for further energy shocks as inventory level is high as the region adjusts to a prolonged Russian-Ukraine war. This should help alleviate concerns around a further spike in inflation figures should the war take a turn for the worse.

Meanwhile in Japan, border re-opening since last October didn't quite help bring about a strong recovery in economic activities. In fact growth momentum is showing signs of slowing as exports declined amid weakening global demand especially those from US and Europe. We are skeptical that China re-opening could give Japan a much needed lift. Despite being stuck in a deflationary spiral over the past three decades, Japan did not welcome the current strong inflationary environment as it is costs led rather than demand driven. The weakening yen has further exacerbated the problem to the point it is affecting consumption. While BOJ recently maintained that they will not tweak monetary policy due to supply side issues, we do think a further widening of the yield curve control could not be totally ruled out. We believe BOJ will continue to curb excessive weakness in the Yen while adopting a gradual change to monetary policy if needed.

Asian credit market continued its strong rally towards the end of 2022 on the back an expectation of a more gradual rate hike by the US Fed coupled with positive sentiment around China's re-opening. Valuation for investment grade bonds are now tighter than historical average. Nevertheless, we remain positive on the credit fundamentals of Asian IG and we expect little credit rating changes from here. Supply is also likely to remain soft and hence supportive for bond's demand and supply technical. Should the Fed continue to bring terminal rate higher, the high all in yield of close to 6% would make Asian Investment Grade bonds too

attractive to ignore. In other words despite of a cautious global economic outlook, we remain constructive on Asian IG. Asian High Yield led by Chinese properties bonds have done very well of late and is likely to take a pause. We do believe the worse could be over for this sector though we do need to see pre-sales figures improving significantly before bond prices can move higher from here. Following a strong run in the past few months, Asian currencies retraced some of its gain as the dollar regained some ground as market started pricing in a higher terminal Fed fund rate. We do believe this trend may continue a little longer though any further weakness could provide investors a more attractive entry point into Asian currencies. We also expect most Asian central banks to be on hold as inflation figures look relatively benign when compared to developed market peers.

Source : Company data, First Sentier Investors, as of end of March 2023

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